

National Grid response to Ofgem's call for input – Energy Networks ring fence review

7 November 2024

This response to Ofgem's call for input on "*Energy Networks ring fence review*" dated 18 September 2024¹ is from National Grid plc (NG), on behalf of our transmission business, National Grid Electricity Transmission plc (NGET), and electricity distribution business, National Grid Electricity Distribution (NGED).

National Grid welcomes the opportunity to respond to this consultation.

The importance of a financially resilient sector

The energy networks are a vital part of the national infrastructure, and we agree with the central premise of the call for input that it is in consumers' interests to have the right regulatory arrangements and protections in place to achieve a financially resilient sector.

We agree with the objectives of the ring fence conditions as stated in the call for input, and that primary responsibility for the financial resilience of a network company lies with the company's management and shareholders. We further agree that the regulatory ring fence arrangements should be reviewed periodically to ensure they are fit for purpose, and that it would not be efficient to "*create a sector in which no licensee could ever fail.*"²

As referenced in the call for input, Ofgem has recently reviewed the ring fence conditions and decided, in the RIIO-3 Sector Specific Methodology Decision (SSMD), to strengthen the conditions as follows:

- amend the Availability of Resources requirement to board certification stating that, based on the agreed assumptions, the licensee has sufficient financial resources to cover the entire price control period or a minimum of three years ahead,
- modify the credit rating licence condition to require companies to maintain more than one investment grade rating, and
- strengthen the dividend lock-up trigger from 'BBB- with a negative outlook' to the earlier of 'BBB- with a negative watch/outlook' and 75% net debt to regulatory asset value.

We expect these changes to be introduced into licences as part of the RIIO-T3 changes with effect from 1 April 2026.

Ofgem has also introduced additional reporting requirements which have already been implemented in the Regulatory Instructions and Guidance (RIGs) for RIIO-2:

- Increased disclosure around distributions along with narrative explanations,
- Disclosure around debt covenant trigger events, and
- Disclosure around MidCo or HoldCo financing including any implications this may have on the licensee.

These additional measures are intended by Ofgem to help achieve the objective of a more financially resilient sector and we would be happy to engage with Ofgem on how the SSMD decisions can be most effectively implemented.

Lens of the review

The significant levels of investment required in the electricity sector mean investability needs to be a key focus area for Ofgem and we are pleased that Ofgem recognises this. However, we are concerned that the call for input suggests Ofgem may consider it possible to consider financial resilience and investability in isolation. The sector will not be financially resilient if it is not deemed attractive and investable.

Ofgem needs to be cautious in making further changes to the ring fence conditions, as changes, or even the risk of further changes, could undermine financial resilience by increasing investor concerns about whether they will see an adequate return on their capital, or the reliability of that return. The call for input refers to challenges in the water sector, but a significant part of the coverage of that sector concerns investors being unwilling to provide additional finance. Concerns are not limited to the water sector however with the Global Infrastructure Investment Association (GIIA) Q2 2024 pulse survey saying "*the United Kingdom continues to languish behind its main competitors in its*

¹ [Energy Networks ring fence review \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/publications/energy-networks-ring-fence-review)

² Call for Input, page 5

*attractiveness to global investors*³. It was also recently reported in Utility Week that some international investors are now not looking at investments in UK regulated infrastructure with reports of one investor saying “*the UK is totally off our radar at the moment*” because regulators have become “*too unpredictable*”⁴

While supportive of the objective of ensuring a financially resilient sector, we are surprised that Ofgem has launched the call for input so soon after the changes referred to above, some of which have yet to be implemented into the relevant licences, particularly given the statement made by Ofgem in the Sector Specific Methodology Consultation (SSMC) that “*we consider these financial resilience measures to have been broadly effective in helping to incentivise shareholders and management to maintain financial policies and outcomes that are consistent with a financially resilient sector.*”⁵ While the SSMD did state there could be “*potential shortfalls or disadvantages of the existing measures*”⁶, investors could reasonably expect the proposals included within the SSMD, and subsequently decided in the SSMD, were Ofgem’s response to any such issues. While investors may have expected the SSMD measures to be consulted on for the electricity distribution networks, the call for input moves onto additional potential measures before the SSMD changes have even had chance to take effect, without providing any evidence to substantiate that there are further problems to solve or recognising Ofgem’s recently stated view that the measures (before strengthening) were already effective and consistent with a financially resilient sector.

The call for input doesn’t include any reference to the word ‘investability’. Instead, it appears to ask what further measures Ofgem could introduce to address “potential” issues. Rather than ask what could be done, the call for input should be considering what should be done. To answer that question, it is critical that any review be conducted through a lens that gives significant weight to the need to ensure investability.

Some measures could endanger financial resilience

The financial ring fence can be seen as a means of protecting the existing assets and capital of the licensee. The protection of existing capital is important, but in the context of the energy transition and need for significantly increased levels of capital expenditure, it is the willingness of investors to provide fresh additional capital that is most important to the financial resilience of the sector. The primary focus needs to be on ensuring capital flows into the networks, rather than whether capital could be extracted.

In this context, some of the proposals in the higher intervention approach could actively hinder financial resilience. For example, a further tightening of the dividend lock up to prohibit interest payments on loans from intercompany entities, shareholders or related parties on normal commercial terms may make investors less willing to provide such loans. For a network facing an actual or potential dividend lock up, loans such as these may be the only or most efficient form of finance available, so measures to discourage them could harm resilience.

Other measures are likely to increase costs for consumers with little or no consumer benefit. For example:

- A requirement to hold specific sums in reserve facilities would involve setting up facilities that are not expected to be utilised but would increase the financing costs of the networks and would need to be funded by consumers.
- Measures concerning debt issued above the licensed entity could also increase costs for consumers. One of the reasons shareholders raise debt above the licensee is to achieve the return they require from their investment. In doing so they take on the risk that the licensee is unable to pay a dividend to service any such debt. The lock up provisions, and additional measures from the SSMD, already ensure the licensee can only pay a dividend if it has sufficient financial resources to do so. If shareholders cannot use debt above the licensee to achieve their required return they will either not invest, or the allowed returns of the licensee will have to increase to attract the necessary investment. Ofgem has always been clear that corporate structures beyond the licensee are beyond its purview and that the risks and rewards of such structures fall to shareholders.

Any review by Ofgem should also consider broader Ofgem policy positions. While Ofgem’s regulatory practice has been to target credit metrics supporting a rating of at least BBB+ / Baa1, the SSMD appears to indicate a weakening of Ofgem’s commitment to a financially resilient sector by suggesting that financeability be assessed against a weaker rating. The SSMD says “*We consider that managing the price control to meet the specific credit metrics associated with a BBB+/Baa1, either by year or over the control period, may not be in the interests of consumers and would not be required to meet our duties to have regard to the need to ensure that network companies can finance their*

³ [Infrastructure Pulse Q2 2024.pdf](#), Foreward

⁴ [Weekend press: Thames Water admits it could run out of cash by December - Utility Week](#)

⁵ RII0-3 Sector Specific Methodology Consultation – Finance Annex, para 6.8

⁶ RII0-3 Sector Specific Methodology Consultation – Finance Annex, para 6.11

activities. We also note that a BBB/Baa2 investment grade rating (rather than the higher BBB+/Baa1 rating suggested as required by the Network companies) would meet associated licence requirements.⁷

Targeting a rating of BBB rather than BBB+ could do far more damage to the financial resilience of the sector than any potential benefits from the measures currently being considered in the call for input. There is a strong rationale that a BBB+/Baa1 rating is critical to ensuring access to capital during what is expected to be a period of significantly heightened capex for the electricity transmission sector. A lower target rating contradicts the aims of the review of the ring fence conditions and sends a strong signal that Ofgem would not be concerned if networks had their credit ratings downgraded, and that financial resilience is less important than it used to be. It would also likely increase debt costs and so increase costs for consumers, whereas measures to maintain a BBB+ rating are typically cost neutral for consumers.

When making policy decisions or changing licence conditions etc. it is important that Ofgem considers both the costs and benefits for consumers, financial resilience and investability. As explained above, a number of the options being considered by Ofgem are likely to be detrimental to financial resilience and / or increase costs for consumers with little or no benefit.

A detailed review should focus on the right things

We do not support the option 2 higher intervention approach. At this stage it is not clear to us that any further changes to the ring fence conditions beyond those decided in the SSMD would be in the interests of consumers. We do support Ofgem's proposal for a detailed review and targeted approach, provided it gives significant weight to ensuring the sector is investable.

The review needs to be broader than the financial ring fence conditions and to focus on financial resilience, i.e. it needs to focus on the desired outcome (financial resilience) rather than just on one of the ways in which that outcome is achieved (the ring fence conditions).

We would also encourage Ofgem to look closely at the substantial information it already receives from licensees, for example, through the Regulatory Financial Performance Reporting (RFPR) process and consider whether sufficient use is made by Ofgem of the information already provided. If Ofgem has any concerns with the completeness or quality of the information reported to it or with a network's compliance with existing ring fence obligations or the resilience of that network's financial structure more generally, we would encourage Ofgem to discuss this directly with the network concerned before seeking to implement further one-size-fits-all measures.

In performing a detailed review Ofgem should be considering the trade-off between accepting a relatively certain increase in costs to consumers (be that to fund a reserve requirement or additional resilience monitoring etc.) and an unknown but potentially larger anticipated cost in the event a licensee suffers financial distress.

In this context, some of the possible additional measures are likely to result in a relatively small additional cost, such as those that increase transparency or improve the clarity of obligations. For these measures Ofgem should consider whether the reduced likelihood of financial distress is a benefit that outweighs such a cost.

Where Ofgem believes obligations need to be clarified (for example, due to unclear definition of terms) we would be happy to work with Ofgem to achieve the required clarity and would encourage such clarifications to be included in the licence conditions themselves.

Equally, following the review, Ofgem may conclude that no or minimal changes are required so soon after the changes it has already enacted and those it has decided on but has not yet implemented. Such an outcome should be viewed as a positive reflection of the existing provisions rather than a missed opportunity.

Some of the proposals in the call for input offer at best potentially marginal benefits to consumers such that there is a risk that Ofgem is looking in the wrong places. It is not clear, for example, why Ofgem's call for input appears to be focussed on onshore energy networks. Offshore transmission owners (OFTOs) are generally less financially resilient than the onshore equivalents and often have far higher gearing than the 75% level that is to be used for dividend lock ups for onshore energy networks.

Ofgem should also ensure the ring fence licence conditions for Competitively Appointed Transmission Owners (CATOs) are equally as strong as those for onshore energy networks with a requirement for two investment grade credit ratings, and dividend lock up at the earlier of reaching BBB- with a negative watch/outlook and 75% net debt to regulatory asset value. If the ring fence conditions are set to be weaker than those of the current regulated networks,

⁷ RII0-3 Sector Specific Methodology Consultation – Finance Annex, para 5.33

this could signal that financial resilience is less important for critical infrastructure investments delivered through competition.

Furthermore, the interests of consumers may be better served by seeking to minimise the cost to consumers of the Special Administration Regime for energy network licensees. Unlike the energy retail sector, energy networks have substantial RAV balances that could (with appropriate changes) be used to help minimise the likelihood and quantum of any costs consumers may bear if a network was to be placed into energy administration. This is a topic that Dieter Helm has written about in the context of Thames Water⁸.

Finally, it would be helpful for Ofgem to clarify the process (and the timing of such process) it would intend to follow for conducting a review and implementing any changes that may emerge from any such review. In particular, we note that the changes to the ring fence for RIIO-GD&T3 have already been consulted on and decided in the SSMD, and any further changes may also need to be applied to other sectors/licensees, e.g. ED, OFTOs, outside of the scope of RIIO-GD&T3.

⁸ [Putting Thames Water into special administration and breaking it up - Dieter Helm](#)

Appendix
Responses to the question raised in the consultation

Q1. Have we identified the issues and challenges network companies are facing accurately?

We agree that many networks have been acquired by private equity, and that the corporate structures of some energy networks have become more complex, since the ring fence conditions were introduced. We also agree there have been challenges with financial resilience in other sectors. However, we also note that the ring fence conditions have been reviewed and strengthened several times, with the latest review as part of the SSMD being after each of the challenges identified by Ofgem had become apparent.

Q2. Are there any other issues that may pose a threat to the regulatory ring fence that we should consider?

As explained above, the SSMD contained a worrying suggestion that Ofgem may choose to target a credit rating of BBB/Baa2 when it performs a financeability assessment of the price control, rather than the previous practice of targeting a rating of BBB+/Baa1.

Not only does this suggestion contradict Ofgem's generally positive messaging about the importance of investability and financial resilience but it also increases the risk that the ring fence conditions will be called upon. We would strongly encourage Ofgem to commit to targeting a BBB+/Baa1 rating as part of its financeability assessment.

Q3. Are there any weaknesses within the current ring fence conditions that we should consider?

We do not necessarily think there are weaknesses in the current ring fence conditions but do think there is a risk to financial resilience that needs to be addressed.

When the ring fence conditions were introduced, their primary focus was on protecting the assets and capital of the licensee and reducing the risk from additional business activities etc. While these issues remain relevant, the bigger threat to financial resilience now stems from the need to attract capital to the sector (for electricity at least).

It used to be possible to fund required investment in the networks through a combination of debt and retained earnings, but this is no longer the case in electricity transmission. The scale of investment required for net zero is such that additional equity needs to be raised by the licensees. The bigger threat to financial resilience is therefore a failure to give adequate weight to the importance of investability.

We therefore encourage Ofgem to put investability at the heart of any detailed review of financial resilience, and to focus not just on whether to strengthen the ring fence conditions but on whether Ofgem's broader policy positions support ensuring the financial resilience of the energy networks.

Q4. Which would be your preferred option of the three outlined and why? And Q5. What are your views on the three options outlined and the associated benefits and risks of each?

As explained in the main response above, we do not support the higher intervention approach. We firmly believe, in the context of a need to ensure the sector is investable, some of the measures proposed could hinder rather than improve financial resilience, while others will increase costs for consumers with little apparent benefit.

At this stage Ofgem has not presented any evidence to demonstrate there is a problem with the ring fence conditions that is not already expected to be addressed through the changes recently introduced or, in the case of the SSMD, decided but not yet introduced. We therefore consider maintaining the existing approach to be a viable option as we believe the existing measures strike the right balance between consumer protection and licensees' flexibility to choose their financing structure. We also think Ofgem should take comfort from the fact that energy network companies are not suffering the financial distress currently being experienced elsewhere and this will, in part, be because historically Ofgem's policies have tended to address resilience risks better than those of the water sector.

We appreciate however that the current issues faced elsewhere may increase the requirement for a review. We therefore support a detailed review and targeted approach but believe that review should be focussed on financial resilience more broadly rather than focussing solely on potentially strengthening the ring fence conditions. Given the criticality of investability, a detailed review must consider the lens of investability and not just whether further restrictions could be introduced.

If the outcome of a detailed review is that no changes should be made, such an outcome should be viewed as a positive reflection of the existing provisions rather than a missed opportunity.

Q6. Tell us if you have suggestions on how we can improve our proposed options.

As explained elsewhere in this response we have two suggestions for the review. First, the review needs to be broader than the financial ring fence conditions and to focus on financial resilience, i.e. it needs to focus on the desired outcome (financial resilience) rather than just on one of the ways in which that outcome is achieved (the ring fence conditions). Extending the review in this way would allow it to include issues such as whether a rating of BBB+ or BBB is targeted for a financeability assessment.

Second, the detailed review must attach significant weight to investability. The biggest risk to financial resilience in the electricity sector is a failure to attract sufficient capital to the energy networks rather than the risk that the current ring fence conditions do not adequately protect the assets and capital already invested in the networks.

Q7. Tell us about any alternate options we should consider.

As explained in our main response above, there may be other things that Ofgem should consider that may do more to improve financial resilience in the energy sector or reduce the consumer impact in the event of financial distress.

Ofgem's call for input appears to be focussed on the existing onshore energy networks. OFTOs are generally less able to accommodate cash flow shocks and so may be less financially resilient than the onshore equivalents. They also often have far higher gearing than the 75% level that is to be used for dividend lock ups for onshore energy networks.

Similarly, Ofgem should ensure the ring fence licence conditions for CATOs are equally as strong as those for networks licensees with a requirement for two investment grade credit ratings, and dividend lock up at the earlier of reaching BBB- with a negative watch/outlook and 75% net debt to regulatory asset value. If the ring fence conditions are weaker than those of the current regulated networks, this could signal that financial resilience is less important for critical infrastructure investments delivered through competition.

Finally, the interests of consumers may be better served by seeking to minimise the costs to consumers of the Special Administration Regime for energy network licensees. Unlike the energy retail sector, energy networks have substantial RAV balances that could (with appropriate changes) be used to help minimise the likelihood and quantum of any costs consumers may bear if a network was to be placed into energy administration.